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Economic Outlook

Irving Trust

Irving Trust Company
One Wall Street
New York, NY 10015

Economic Research &
Planning Division

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The basic pattern of economic growth continues unchanged from 1987. In late 1986, the U.S. economy shifted away from consumer-led growth to export and investment-led growth (Table). Recent statistics point to more of the same for the balance of 1988. Employment statistics for April and May suggest second quarter GNP growth in the 3 1/2 - 4% range, roughly maintaining the 4% average of the prior five quarters. The latest purchasing managers' reports also point to good second quarter growth.

Contribution to Real GNP Growth
Percent Annual Rate

	Actual 84II-86IV	Actual 86IV-88I	Forecast 88I-89I
Consumer	2.6	1.1	1.0
Investment	0.2	0.9	0.9
Residential	0.3	-0.2	-0.2
Inventory	-0.7	0.8	0.3
Net Exports	-0.7	0.7	0.7
Government	0.9	0.7	0.3
Total	2.6	4.0	3.0

Consumer spending is contributing less than half as much to GNP growth as it did in the 1984-1986 period, when the industrial sector was in the doldrums (Table). Many economists think even the current modest growth in consumer spending is unsustainable because of heavy debt loads and inadequate real income gains. But the Great American Job Machine is still chugging along and in May the Conference Board index of consumer confidence reached its highest level since 1969. Real incomes are picking up again as overtime and faster wage growth in a tight labor market outpace inflation. One risk to our outlook for a modest deceleration in growth is that the consumer sector may gather steam as the year progresses and the job market heats up.

Business investment is running full speed ahead, adding about as much to GNP growth as the much bigger consumer sector. The backlog of unfilled orders for durable goods is still building at double-digit rates, virtually guaranteeing several more months of strong production. Aside from the producer durable equipment category, which has been strong for quite a while, construction spending on industrial plant is up almost forty percent over the last year, showing a whopping 8.8% rise in April alone. In fact, the May Commerce Department survey found businesses plan to spend almost 12% more on plant and equipment in 1988 than in 1987. Capital spending plans for 1988 have been revised upward in successive surveys, as a better than expected economy fuels business confidence. The previous Commerce survey, taken just a few months earlier, suggested capital spending would grow about 8% in 1988. These developments are in line with the strong contribution we expect from investment as the year unfolds. The need for additional industrial capacity should feed this trend for quite a while.

Surging exports are feeding the trend as well. Real merchandise exports were up 25% over the last year, showing further acceleration in the first quarter. While import growth is likely to remain positive in this solid economic environment, the trade sector should still add significantly to economic growth as it has for over a year. Grain exports at much higher prices may also help the nominal trade deficit improve.

One surprise in the first quarter GNP numbers was the continued high level of inventory investment. Despite a steep decline in domestic car inventories, overall inventories were up substantially, as capital equipment and primary metals moved through the production pipeline. Huge order backlogs and healthy capital goods demand will sustain high inventory levels, but inventory growth should moderate as stocks approach desired levels. The drop in car inventories and buoyant sales have boosted car production, which will make an important contribution to second quarter growth.

The primary concern over the next several months will be inflation. Interest rate increases to date are unlikely to have much impact in a robust business environment with confidence quite high. Various inflation indicators have risen in the first half of 1988 and it is not likely they will decline on a sustained basis until the U.S. and world economy cool off some. As a result, the bias in financial markets will be toward higher interest rates. Preemptive monetary tightening seems unlikely, however, with the world's monetary authorities showing a clear preference for gradual restraint in 1988. The result will be continued economic expansion with inflation drifting higher.

Robert T. McGee

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual				Forecast				Actual	Forecast	
	1987			1988	1988			1989	1986-	1987-	1988-
	II	III	IV	I	II	III	IV	I	1987	1988	1989
Consumer Spending	1.2	3.5	-1.7	2.8	1.6	1.1	0.8	0.6	1.3	1.5	0.5
Business Investment	1.3	2.8	0.2	2.3	1.6	0.9	0.8	0.4	0.1	1.5	1.0
Residential Investment	-0.2	-0.4	0.4	-0.5	-0.1	-0.1	-0.1	-0.2	0.0	-0.2	-0.2
Change in Inventories*	-1.6	-1.5	4.9	-2.2	0.1	0.3	0.4	0.5	0.4	0.1	0.0
Net Exports	0.3	-0.6	0.3	1.7	0.4	0.7	0.7	0.8	0.3	0.7	0.6
Government Purchases*	1.5	0.5	0.7	-0.2	0.3	0.3	0.3	0.3	0.8	0.3	0.4
Real GNP	2.5	4.3	4.8	3.9	3.9	3.2	2.9	2.4	2.9	3.9	2.3

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual				Forecast				Actual	Forecast	
	1987			1988	1988			1989	1986-	1987-	1988-
	II	III	IV	I	II	III	IV	I	1987	1988	1989
Nominal GNP	6.3	7.3	7.3	5.4	8.3	8.1	8.4	8.0	6.0	7.2	8.5
GNP Deflator	3.5	2.8	2.7	1.7	4.0	4.8	5.2	5.5	3.0	3.2	6.1
Corporate Profits After Tax#	10.0	9.0	8.7	13.5	10.0	8.5	6.9	6.4	8.7	9.3	6.4

Monthly Economic Indicators

	Recent Data			Actual	Forecast	
	Mar.	Apr.	May	1987	1988	1989
Consumer Price Index** (%)	0.5	0.4	n.a.	4.4	5.3	6.2
Industrial Production (%)	0.2	0.7	n.a.	3.7	5.1	2.7
Retail Sales (%)	1.7	-0.6	n.a.	5.1	5.4	5.2
Auto Sales (million units, a.r.)	10.7	10.5	10.2	10.3	10.3	8.8
Housing Starts (million units, a.r.)	1.55	1.56	n.a.	1.63	1.50	1.35
Unemployment Rate (%)	5.6	5.4	5.6	6.2	5.5	5.5
Merchandise Trade Balance ($ bn., a.r.)	-117.0	n.a.	n.a.	-171.2	-145.0	-110.0

*Adjusted for CCC purchases. **Annual percent changes are December to December. June 9, 1988
#Quarterly data are year-over-year percent changes.
a.r. = annual rate